TRUTH IN LENDING REIMBURSEMENT

IN THIS APPENDIX

OVERVIEW

This Appendix provides information relating to the identification of reimbursable Truth in Lending violations, reimbursement calculations, and for the determination corrective action.

Objective(s)

The objectives of these procedures are to provide:

- General guidance for identifying and calculating reimbursable violations
- Proper treatment of these violations in the Report of Examination

REIMBURSEMENT GUIDELINES

In dealing with Truth in Lending reimbursement, the examiner needs to be familiar with the following guidance:

- Truth in Lending Act
- "Administrative Enforcement of the Truth in Lending Act – Restitution", FFIEC Joint Statement of Policy
- FFIEC's Questions and Answers on Truth in Lending Reimbursement (Q&A)

REIMBURSEMENT

Section 108(e)(2) of the Truth in Lending Act (Act) directs that the FDIC shall require "adjustments" (monetary reimbursement) to consumers for understatements

GUIDELINES (cont'd)

Regulatory Actions

of annual percentage rates (APR) or finance charges (FC). Unless other statutory or regulatory exemptions are met, the FDIC is required to seek reimbursement and may not waive or grant relief from reimbursement. If an institution does not voluntarily comply with the law and make reimbursement, Section 108(e)(4) of the Act authorizes the FDIC to order institutions to make monetary adjustments to the accounts of consumers where an APR or FC was understated.

In 1980, the FFIEC adopted a Joint Statement of Policy entitled "Administrative Enforcement of the Truth in Lending Act – Restitution" (Policy Guide) that summarizes and explains the restitution provision of the Act. The Policy Guide is reproduced in FDIC's looseleaf Rules and Regulations service under the "FDIC Statements of Policy" tab.

The Policy Guide states that, in general, the FDIC must require (and may order) restitution when understatement of the cost of borrowing results from ***a clear and consistent pattern or practice of violations, gross neglect, or a willful violation*** intended to mislead the consumer. This parallels the reimbursement requirements of Section 108(e)(2) of the Act. In such instances, a file search may be requested to detect loans containing specific problems requiring reimbursement. The request is made by the Regional Office or, if permitted by Regional policy, may be made by the Examiner-in-Charge (EIC).

While the Act and Policy Guide set the definitive general principles as to when reimbursement is required, the FFIEC's interpretive Questions and Answers on Truth in Lending Reimbursement (Q&A) regarding the Policy Guide provide guidance as to applying the principles to given situations. The Q&A are included in this Appendix. The Q&A were originally issued in 1980, with additional interpretations added from time to time.

Required Corrective Action

Under provisions of the Act, a financial institution will generally have no civil liability (Section 130(b)) or regulatory liability (Section 108(e)(6)) if it takes two affirmative corrective actions. Within 60 days of "discovering" an error (but before institution of a civil action or receipt of a written notice of error from a consumer, the financial institution must both:

- Notify the consumer of the error, *and*
- Reimburse the consumer for overcharges

REIMBURSEMENT GUIDELINES (cont'd)

Required Corrective Action (cont'd)

An error is "discovered" if the institution either identifies the error through its own procedures or if it is disclosed in a written examination report.

If the financial institution attempts to correct a disclosure error by merely redisclosing the required information accurately, without reimbursing the consumer, correction has not been effected. Consumer reimbursement is an inseparable part of the correction action.

FFIEC Q&A 11 indicates that the institution must make a cash payment or a deposit into an existing unrestricted consumer asset account, such as an unrestricted savings or NOW account. However, if the loan is delinquent, in default, or has been charged off, the creditor may apply all or part of the reimbursement to the amount past due, if permissible under law.

Corrective Action Period

Open-end credit transactions will be subject to an adjustment if the violation occurred within the two-year period preceding the date of the current examination.

Closed-end transactions will be subject to an adjustment if the violation resulted from a clear and consistent pattern or practice or gross negligence where:

- There is an understated APR or understated FC, and the practice giving rise to the violation is identified during a current examination. Loans containing the violation which were consummated since the date of the immediately preceding examination are subject to an adjustment

- There is an understated APR or understated FC, the practice giving rise to the violation was identified during a prior examination and is not corrected by the date of the current examination. Loans containing the violation which were consummated since the financial institution was first notified in writing of the violation are subject to an adjustment. (Prior examinations include any examinations conducted since July 1, 1969.)

Variable-rate transactions consummated after September 30, 1984 where the initial rate is discounted from the index rate used for later adjustments and results in a clear and consistent pattern or practice or gross negligence involving an understated APR or understated FC will be subject to an adjustment.

REIMBURSEMENT GUIDELINES (cont'd)

Corrective Action Period (cont'd)

Each closed-end credit transaction containing a willful violation intended to mislead the consumer consummated since July 1, 1969 is subject to an adjustment.

For terminated loans not previously identified as having an understated APR or FC, an adjustment will not be ordered if the violation occurred in a transaction consummated more than two years prior to the date of the current examination.

Tolerances and Calculation of Reimbursement

Illustrated below are the tolerances to be applied in calculating the amount of the adjustment to a consumer's account.

- For loans involving a willful violation and containing understated APR violations, a tolerance of 1/8% applies
- For loans granted April 1, 1982 or later which contain understated APR violations which did not result from a willful violation:

	Amortized 10 Years or Less	Amortized Over 10 Year
Regular Loans	1/4	1/8
Irregular Loans	1/4	1/4

Nondisclosure of the APR or FC

Nondisclosure of the APR or FC
1. If the APR was not disclosed, use the contract rate.
2. If the contract rate was not disclosed, use the actual APR (calculated by the examiner) less one percent. For first lien mortgage loans, use the actual APR less ¼ percent.
3. No adjustment will be ordered where a FC was not disclosed.

REIMBURSE-MENT GUIDELINES (cont'd)

CREDIT LIFE, ACCIDENT, HEALTH, OR LOSS OF INCOME INSURANCE

In general, treatment of credit insurance premiums is covered by Sections 106(b) and (c) of the Act and by Section 226.4 (d) (1) of Regulation Z. It is also covered in Paragraph 4(d) of the Federal Reserve's Official Staff Commentary to Regulation Z.

Improper Disclosure of Insurance

Required Insurance Coverage

Credit insurance coverage required by the institution as a precedent to obtaining the loan is a cost of credit and must be included in calculations for the APR and FC. Failure to do so may lead to an understated APR and FC.

Optional Insurance Coverage

When credit insurance coverage is not required by the financial institution as a precedent to obtaining a loan, the cost of the insurance premiums are not a cost of credit. They may be excluded from APR and FC calculations only if full credit insurance disclosures are properly made. Failure to do so may lead to an understated APR and FC.

Credit insurance disclosures must be made in writing. Verbal disclosures are not acceptable. *All* three elements of the disclosures must be present:

1. A statement that the insurance coverage is optional and is not required by the financial institution, and

2. The cost of the premium for the initial term of the insurance coverage, and

   Cost

   - In most closed-end loans, insurance must be disclosed as a total dollar amount. However, insurance may be disclosed on a unit-cost basis (for example, $1 per $1,000 of the amount financed):

     -- Where the insurance plan limits the total amount of indebtedness subject to coverage, or

     -- Involving mail or phone transactions without face-to-face or direct telephone solicitation

     See Paragraph 4(d)(4) of Regulation Z's Official Staff Commentary.

   - In open-end credit, insurance is disclosed on a unit-cost basis

REIMBURSEMENT GUIDELINES (cont'd)

Optional Insurance Coverage (cont'd)

Term

- If the term of the insurance is less than that of the transaction, the term of the insurance coverage must also be shown
- If the term is unclear, such as when premiums are paid periodically and the consumer is under no obligation to continue making the payments, premiums may be disclosed on the basis of a one-year period, but the one-year period must be clearly labeled

Refer to Paragraph 4(d)(11) of Regulation Z's Official Staff Commentary.

3. The customer's signature or initials signifying an affirmative desire for the optional insurance coverage.

Grouping of Insurance Disclosures

Separated disclosures are acceptable. The three required credit insurance disclosures are not required to be located in the "Federal Box" or even on the primary Truth in Lending disclosure form. In addition, they do not need to be grouped together, or even appear on the same page. *Refer* to Footnote 38 to Regulation Z.

Unacceptable Alternatives

Substitute disclosures do not satisfy Truth in Lending requirements. For instance, a consumer's signature at the bottom of the Truth in Lending disclosure form, acknowledging receipt of the form, is not an acceptable substitute for a separate signature or initial specifically affirming a desire for the optional insurance coverage. In a similar manner, coverage of the insurance premiums in the itemization of the finance charge does not substitute for the requirement to state separately the cost of the insurance within the credit insurance disclosure. Likewise, disclosure of separate elements of the disclosures on other forms, such as itemization of the premiums on a HUD-1 form for mortgages, or signing an insurance company's application form, do not satisfy the credit insurance disclosure requirements of Truth in Lending.

REIMBURSEMENT GUIDELINES (cont'd)

Credit Insurance Legal Opinion

In a series of related opinions dated January 29, February 8, and September 5, 1985, the Legal Division indicated that understated APR's and FC's stemming from faulty credit insurance disclosures were reimbursable violations that, by statute, required reimbursement. The opinions indicated that such violations were substantive, and not merely technical, violations. The opinions further stated that, except for the statutory exemptions in Section 108 of the Act, the FDIC must mandatorily require the financial institution to reimburse consumers and could not grant relief from reimbursement.

Obvious Errors

When either the APR or FC was understated and the other was correctly disclosed, Section 108(e)(2)(B) of the Act states that no adjustment will be required if the understated APR or FC was "10 percent or less of the amount that should have been disclosed." This means that the APR or FC is understated by 90% or more of what should have been disclosed, in order to qualify for the "obvious error" exemption from reimbursement.

Current Examination Legal Opinion

Section 108(e)(3)(i) of the Act provides that reimbursement shall not be required by institutions ". . . except in connection with violations arising from practices identified in the current examination and only in connection with transactions that are consummated after the date of the immediately preceding examination ...." This led to various interpretations that FDIC would be "time-barred" from seeking (or ordering) uncompleted reimbursement found in the preceding examination once a subsequent examination took place.

In a March 28, 1989 opinion, the Legal Division concluded that such a time-bar does not apply to this situation. The thrust of the opinion is that the statute's reference to "the current examination" deals with the examination during which the reimbursable violations were found. This examination always remains the "current examination", for purposes of curing the reimbursable violations, until reimbursement is accomplished.

As a result, there is no statutory "time-bar" prohibition against conducting subsequent compliance examinations or visitations which cover Truth In Lending. However, in order to avoid the frequent raising of this defense in connection with pending relief from reimbursement cases, reexaminations should be deferred during the pendency of the request, if possible.

REIMBURSEMENT GUIDELINES (cont'd)

Effect of Reimbursement on Bank Capital

Often, a financial institution attempts to use the impact of reimbursement on its capital as a defense against having to make any reimbursement at all. This is not an acceptable defense.

Section 108(e)(3)(A) indicates that even if reimbursement "would have a significantly adverse impact upon the safety and soundness" of the institution, full reimbursement is still required. The only option permitted to the FDIC by the Act in such circumstances is to "permit the [financial institution] to make the required adjustment in partial payments over an extended period of time which the FDIC considers reasonable."

Other Unacceptable Defenses

Since provisions of the Act provide a "decision tree" indicating those points which the FDIC must consider in granting relief from reimbursement, anything outside of the Act's provisions is an unacceptable defense. Some of the more common unacceptable defenses are:

- Size of the institution
- Impact of reimbursement on the institution's reputation
- Previous examinations did not find the violation
- Examiners previously gave erroneous advice
- Redisclosure was made to consumers (but reimbursement was not)

Pattern Or Practice

Reimbursement is required by a creditor (financial institution) whenever a "pattern or practice" of reimbursable violations occurs. The term "pattern or practice" is set forth in the Truth in Lending Act. However, a pattern or practice is not defined by the Act, Regulation Z, the Federal Reserve's Staff Commentary to Regulation Z, the Policy Guide, or FFIEC's interpretive Questions and Answers. Therefore, it is something of a term of art, which must be applied to individual situations according to the facts and circumstances present.

A pattern or practice occurs when errors stem from a common cause, usually within one type of consumer credit which often has certain common characteristics. For instance, failure to obtain customer signatures for credit insurance in mortgages with credit insurance coverage.

REIMBURSE-MENT GUIDELINES (cont'd)

Pattern Or Practice (cont'd)

A pattern or practice is not represented by a specific number of loans, nor a specific percentage. If an institution makes one loan of a certain type and with certain characteristics, and that one loan has an understated APR or FC beyond permissible tolerances, than that one loan may represent a pattern or practice.

In deciding Truth In Lending cases requesting relief from reimbursement, FDIC's Board of Directors and former Board of Review have ruled that a pattern or practice may occur in one branch of an institution, or through the actions of one officer in an institution.